



Testimony of Denise L. Nappier Treasurer of the State of Connecticut

SUBMITTED TO THE APPROPRIATIONS COMMITTEE
MARCH 28, 2018

Senators Osten and Formica and Representative Walker, and members of the Appropriations Committee, thank you for this opportunity to submit testimony on Senate Bill 6, *An Act Implementing the Governor's Budget Recommendations for General Government*.

I strongly urge the Committee to oppose Section 3 of the bill concerning funding of the Teachers' Retirement Fund (TRF). The Governor's proposal would restructure payments to the TRF by essentially moving the goal post farther down the field. This would violate the bond covenant adopted in 2008 when we issued pension obligation bonds (POBs) that instilled the funding discipline we fought so hard to achieve, triggering a technical default of the State's promise to bondholders.

Connecticut has never before defaulted on its covenants. Once that line is crossed, the rating agencies may take a dim view of our promises, the consequences of which we will face indefinitely. In fact, a recent report from Municipal Market Analytics confirms that any violation would be a "clear credit negative." This technical default and possible rating agency actions would likely reduce market interest in our bonds and increase the State's overall cost of borrowing.

There is a better path forward that could achieve what the Governor is proposing – to mitigate the impact of the sharp rise in the State's pension contributions as we approach 2032 – while maintaining a disciplined approach to funding the State's long-term obligations and honoring our bond covenant.

I have proposed paying off the POBs as soon as all the outstanding bonds are callable. In July 2025, the State could pay off the bonds for roughly \$1.9 billion, using most of the estimated State contribution for that fiscal year. At that point, the bond covenant would disappear and the State then could restructure the amortization of the remaining liability. This option of a one-time diversion of the required employer contribution would not have a major impact on the TRF's unfunded liability, according to the Fund's actuary. In addition, it would allow for future debt service savings of \$260 million in FY 2026 and overall savings of more than \$2 billion.

To help in getting from now to FY 2026, we should consider the asset transfer of the Lottery to the TRF to improve its funding status and help reduce the State's annual actuarially determined employer contributions (ADEC), as put forward by the Commission on Fiscal Stability and Economic Growth. While considerable work must be done to flesh out this idea, and while accounting standards may well interfere with certain options, this concept is intriguing and promising. Securitizing a portion of the lottery's future revenue stream – resulting in an immediate infusion of cash for the pension fund - could be the most viable asset transfer option

to bolster the pension funding status, lower the State's pension contribution, and protect, if not improve, the State's credit rating.

Along with any changes to the funding for the TRF, the General Assembly should adopt strong measures to ensure future funding discipline, including a requirement for supermajority votes, with public notice, for any legislative proposal to pay less than what is deemed actuarially required to meet the State's pension benefit obligations year in and year out.

I also would remind the committee that there is no need to take action this session because the budgetary impact of the changes proposed by the Governor would first occur in FY 2020. Thus, removing Section 3 would not affect your budget deliberations for FY 2019. It would allow a comprehensive analysis of the options on the table, with information shared with all interested parties, followed by careful deliberation among all stakeholders.

Now let me provide some background on the value of the bond covenant and the pension obligation bonds, as well as how we got to this difficult position today.

As a reminder, the 2008 POBs provided \$2 billion in proceeds for deposit into the TRF. As part of the transaction, the legislature approved a covenant that requires the State to annually pay the full amount of the ADEC for as long as the bonds remain outstanding. It also prohibits changes to either the method of calculating the State's contribution or the amortization period for funding the plan, which currently is expected to be fully funded in 2032.

This bond covenant has stood the test of time. Since the redesign of the teachers' retirement plan in 1979 as an actuarially designed plan, the longest period of the State's consistent payment of 100 percent of the ADEC has been during the existence of the covenant. Were it not for the covenant, there would have been temptation for the State to backslide on its commitment.

However, the covenant did result in a closed amortization period that, combined with an unrealistically high investment return assumption, has led to the situation we face today of escalating ADECs.

When the POBs were issued, the return assumption was 8.5 percent. It was not lowered until November 2015 and then only to 8 percent despite my recommendation of an even lower number. I repeat my recommendation that the Teachers' Retirement Board should adopt a more realistic investment return assumption.ⁱ A 7 percent investment return assumption would be more reasonable and consistent with our capital market expectations going forward. The fact that, since the pension obligation bonds were issued, the high return assumption of the Teachers' Retirement System (TRS) has not changed in any meaningful way to align with capital market assumptions is a contributing factor to the projected spike of the State's actuarially required contributions as the close of the amortization period approaches.

As to the POBs, the State has had the benefit of nearly a decade of experience since the bonds were issued. As of December 31, 2017, on a cash flow basis, investment earnings have exceeded debt service payments by approximately \$450 million. In addition, the POB transaction was part

of a larger pension reform initiative, which also included restructuring the financing of TRF COLAs at an estimated \$1.2 billion savings.

In closing, with a pragmatic phase-in of a more realistic investment return assumption, an infusion of cash through an asset transfer, and paying off the POBs as soon as the outstanding bonds are callable, the State will have an orderly and practical path forward for improving the funding status of the TRF while achieving cost savings to ameliorate its future budget challenges.

Thank you.

ⁱ A higher assumed rate of return lowers the unfunded liability and the State's actuarially determined employer contribution (ADEC) because it assumes that the pension fund assets will grow at a higher rate and rise to match the liabilities more quickly. Conversely, a lower assumed return increases the unfunded liability and triggers a higher ADEC payment as assets are projected to grow at a slower rate. Following the 2008-09 historic decline in the capital markets, many public pension funds lowered their investment return assumptions, which in turn increased their unfunded pension liabilities and ADEC payments. TRS maintained its higher return assumption – one of the highest among its peers in the country. While the higher return allowed the State a more manageable ADEC payment, TRF's actual net investment returns for the past 10 years ending December 31, 2017 were 5.6 percent, far below its return assumption, even though it met or exceeded the performance of its peers according to Wilshire Trust Universe Comparison Service and the National Association of State Retirement Administrators.